


## **CRA COMPETITION POLICY DISCUSSION PAPERS 1**

### **Competition and mergers in consumer goods industries**

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## Competition and mergers in consumer goods industries

### Introduction

Fast-moving-consumer-goods (FMCG) producers are presently going through some major organisational changes. In some cases, firms are scaling down their operations to focus on particular markets with re-focusing entailing closures and divestitures. At the same time, firms are often seeking to consolidate positions of perceived core businesses with strategic acquisitions intended to increase their efficiency and market reach. However, these moves have not escaped the watchful gaze of competition authorities intent on ensuring that competition remains effective in consumer goods industries. Competition authorities have regularly sought to investigate mergers and acquisitions of such firms but by and large have allowed mergers to proceed with at worst limited divestitures of various types, typically in the form of brand/product sell-offs or plant/capacity sell-offs. In this way, so the competition authorities reason, the cost-saving benefits from mergers can be allowed while ensuring that market dominance by particular parties can be avoided.

This article considers the assessment of the competitive effects of such mergers by understanding their motivation in the context of the markets in which the firms operate and the nature and developments of the supply chain in which they operate. Essentially, the need is to view competition as existing in a vertical (i.e. between trading parties at different levels of the supply chain) as well as a horizontal sense (between rivals competing to serve similar needs). In regard to FMCG markets, fundamental changes have occurred in the balance of power in the vertical chain following the substantial consolidation of

retail markets now dominated by a very limited number of multiple retail chain-store groups wielding enormous buying power. This has had a profound effect on incentives for producers to re-organise themselves. It is with this background in mind that the present article considers the recent merger activity in the pet food market, including the proposed consolidations of Nestlé/Ralston Purina and Mars/Royal Canin.

### Changing market conditions in the supply of grocery and daily goods

From a situation where retail markets used to be highly fragmented, consisting predominantly of traditional independent retailers, they have become highly consolidated, driven by a process of organic growth and mergers by leading retailers. The result has been the marginalisation of small independent retailers, restricted to acting as convenience stores (for so-called top-up shopping), and market leadership by a limited number of large-format, multiple-store retailers that attract the bulk of consumer spending. The general trend has been one of relentless increase in concentration in most countries. For instance, the combined market share of the top five retailers in the 15 Member States increased by an average of 20% across the EU between 1993 and 1999.

However, it is not just changes at the national level that are taking place. Increasingly, the major retailers have sought to expand internationally. Indeed, the concerted international as well as domestic expansion by the leading food retailers has meant that they are increasingly taking a larger share of

overall sales away from other retailers. The result has been a sharp increase in *aggregate* concentration across the EU. The top ten retailers in the EU now account for over 30% of sales of all food and daily goods, an increase of some 25% in just six years. Moreover, it is clear that the top ten, or at most the top twenty, retailers are pulling away in growth terms from the rest.

Thus it is now the case that a handful of leading players account for a large proportion of retail sales of FMCG products across Europe. It is on these retailers, with their enormous buying power, that the livelihood of most FMCG suppliers depends. With their control of retail markets, the powerful store groups are able to wield their bargaining power to extract beneficial trading terms from suppliers. The superior trading terms obtained by the leading retailers further reinforces their competitive advantage over smaller rivals, which in turn leads to further consolidation at the retail level. The process is one of a virtuous circle for the very largest retailers.

Yet, it is not only the buying power of the major retailers, exercised through their size and control as gatekeepers to consumers, which has shaped the way that suppliers must respond in order to secure sales. As grocery retail markets have consolidated, the leading players have increasingly sought to differentiate themselves one from another, emphasising retail branding and the use of own-label goods to compete directly with the leading brands. The limited availability of in-store shelf-space has meant that secondary and tertiary brands have in many instances been de-listed by retailers to make way for the increased presence of own-label goods. The result has been a fundamental shift in the nature of supplier competition, with an effective market polarisation between firms choosing either to focus on leading brands or produce own-label goods under the direction of the major retail chains, but with fierce competition in either line.

In the case of own-label goods, producers are often put into a bidding situation, where the only guarantee of winning a contract to supply a retailer is by offering the lowest price possible. Hence price-focused, cut-throat competition typically prevails, driving on own-label suppliers to search for efficiencies and cost savings in order to stay in business.

For the leading brand producers, the competitive pressures can be equally strong. For not only do the brand producers have to fight to build and maintain leading brand recognition but they face powerful retailers willing and able to substitute their products for those of rival brands or own-label goods. Thus while investing heavily in brand promotion they are also under pressure to cut costs to remain competitive in pricing terms. The drive for efficiency gains and cutting costs is further intensified by the now prevalent practice of retailers demanding substantial up-front fees for access to shelf-space and key in-store positions. These practices arise from the disparity in relative bargaining power, where it is far more straightforward for a retailer to fill shelf space with another supplier than it is for a supplier to gain extra sales at another retailer.

The internationalisation of grocery retailing has also brought suppliers new challenges. International retailers will themselves look for procurement economies through centralising their buying practices as much as possible. This means that suppliers in different countries may end up competing against one another for contracts that cover several countries. While some global brands exist, most brands are only recognisable at the national level. The desire of retailers to award international contracts will spur brand producers to build or acquire leading brand positions in each of the countries to be served to enhance their chances of winning such international contracts. Similarly, own-label producers will be induced to expand abroad in order to secure international contracts. Accordingly, the internationalisation of retailing and the resulting changes to the way

that the retailers purchase goods will act as a driver for the internationalisation of producers seeking efficiencies and widespread presence in order to secure contracts. Given the time required to build new positions organically, producers may instead be expected to extend and adjust their international reach through strategic acquisitions. It is precisely this aspect which lies behind much of the international acquisition and sell-off activities of leading branded FMCG producers where adjustment to product portfolios is taking place.

Thus for a variety of interrelated reasons the substantial consolidation and internationalisation of grocery retailing in altering the nature of retailing competition has also altered the nature and intensity of supplier competition. FMCG suppliers have been forced to search for available economies in order to remain competitive. While cost-savings have been made through increasing the efficiency of existing capacity and brands supplied, for many producers the only way to increase efficiency further is via mergers and acquisitions and other re-structuring activity to reap economies of scale and product/category specialisation. In this sense, the recent activity of FMCG producers in adapting and enhancing their product portfolios through M&A activity can be seen as a natural and efficient response to the changing retail environment which they now face.

### **The economic impact of mergers between FMCG producers**

While there are clear efficiency advantages to the restructuring activity of producers outlined above, there have nevertheless been concerns expressed that the scale and extent of market share controlled by prospective merged enterprises in key FMCG markets will restrict competition to the public detriment. It is now not untypical in FMCG markets (as narrowly defined on a product or category basis) for one or more producers to have market shares near to or exceeding the 40% level at which European com-

petition authorities have traditionally been concerned about problems of *single-firm dominance* arising. Further mergers in the sector are likely to increase the number of product markets where potential issues of dominance arise. However, as with all merger cases, assessment needs to take into account the actual nature of competition in the market, not simply rely on market shares thresholds being exceeded.

In highly dynamic markets where innovative activity is taking place, high levels of market concentration may be an important factor in enhancing the pace of change by allowing research and development resources to be pooled. It is also in such markets that relative positions are likely to be fluid as market shares may change not just through price competition but through competition to offer superior and/or differentiated goods or services which better serve the needs of customers. Here the market may develop rapidly through a process of innovation by one firm followed by rapid imitation by others and then innovation again, perhaps by another firm, followed by imitation, and so on with each round adding economic value and hence public benefit. In these dynamic market circumstances competition authorities might be expected to be more reluctant to block a merger through concern of impeding the innovative process.

The emphasis on innovation and experimentation with new products and new variations is a typical characteristic of many FMCG markets. Each firm strives to steal a march on its rivals with new product introductions often only to see its rivals subsequently emerge with new products to which it in turn must respond with further innovation. Thus one firm's innovation drives on others to innovate in order to remain competitive in the market and not lose substantial market share. Such characteristics need to be seen not only as pro-competitive but the ultimate drivers of increased economic welfare. Merger control in such circumstances can be detri-

mental not only to the immediate efficiency of firms, where mergers allow for productive efficiency gains, but also to the long-term interests of the market if firms are hampered in supporting R&D and other product investment effort effectively.

In addition to innovation concerns there are a number of economic reasons supporting the need for relatively high concentration levels in FMCG markets. First, economies of scale and scope are typically available, where efficiency advantages come from operating with a large size and providing a wide range of related products. Second, because of the required emphasis on new product development, efforts to innovate involves risk taking and support from significant resources that may be best suited to large, diversified firms. Third, the shift in the balance of power towards retailers has typically polarised supplier competition and forced those firms specialising in branded goods provision (rather than own-label goods) to consolidate in order to preserve brands and thereby consumer choice.

But, behind all of these aspects lies retail buyer power as the ultimate driver of current market changes and as the explanation of why supplier mergers are generally unlikely to reduce competition. Suppliers with even relatively high market shares can still be dictated to by retailers even if those retailers individually have lower market shares of their respective retail market than the suppliers do of their market. The reason for this is down to relative dependency measured in terms of relative switching costs. If a retailer delists a brand, it is far easier for the retailer to find an alternative source to fill its shelves than it is for the brand producer to find a new equivalent outlet. The greater flexibility of the retailer is what affords it buyer power over the producer who has no or only limited outside options. It is this power, in turn, that enables retailers largely to dictate terms and engineer intense price competition even in highly concentrated FMCG markets.

### **Competition and mergers amongst producers of pet foods**

The prepared pet food market has undergone substantial changes over recent years. predominantly focused on the provision of food for cats and dogs (jointly accounting for some 95% of pet food sales), the variety of products has increased considerably with the development of “dry” products in competition to the traditional tinned “wet” food products. The market has grown considerably over recent years and the buoyant conditions have also led to the emergence of new specialists, for example focusing on organic pet foods, nutraceutical pet foods and other new niches. Moreover, as with other FMCG markets, own-label products have competed increasingly strongly with the established brands and their extensive ranges. It is estimated that own-label sales now account for 15% of total pet food sales in the EEA.

The structure of the industry in Europe has changed considerably over recent years with the strong growth of specialist “dry” pet food manufacturers and general consolidation through a wave of mergers and acquisitions. By the end of 2000, Mars possessed market-leading positions in both the cat and dog food categories for the EU as a whole but its share of the wet pet food markets had been eroded since its higher levels in the mid-1990s. Nestlé had consolidated its position as the number two overall and was challenging hard to become the number one cat food producer. Own-label sales ranked collectively at number three in the European market; their strong position highlighting the serious competitive threat posed to brand manufacturers. Royal Canin and Ralston Purina held strong positions in the dry dog food segment and P&G (Iams) had a growing presence through specialist outlets. In addition, a number of national specialists continued to hold good positions and global operators Heinz and Hills Pet Nutrition (owned by Colgate-Palmolive) had small but growing interests in the market.

In the context of comparisons with other consumer goods markets, the pet food industry appears to be relatively concentrated with the leading two players jointly accounting for around 75% of cat food sales and 50% of dog food sales across the EEA. Yet, the level of concentration is expected to rise still further with the announced merger proposals respectively by Nestlé to acquire Ralston Purina and Mars to acquire Royal Canin. The scale of these mergers poses a significant issue to the competition authorities of whether these mergers would be pro- or anti-competitive in the present circumstances. To begin to address this we first need to identify the relevant economic markets for this industry in respect of the product scope and geographic scope.

With regards to products it is clear that there are fundamental differences in the production methods used to produce wet and dry products. Each form requires dedicated production scheduling and different processes and is often carried out at different plants. In terms of consumer demand, pet owners clearly distinguish between cat and dog food. They also distinguish between wet and dry pet foods, tending to see them as weak substitutes or even as complements (where owners seek to mix wet and dry products). Accordingly, it is conceivable that each form for each pet constitutes a separate economic market. In two previous decisions<sup>1</sup>, the European Commission took the view that cat food and dog food were separate markets but no firm conclusion was reached on whether wet and dry foods were economically distinct markets. However, in its decision on *Nestlé/Ralston Purina*<sup>2</sup>, the Commission decided that the market structures of the different segments and the customer needs served were sufficiently different that wet and dry foods were indeed separate markets.

In terms of geographic scope of the market the European Commission had previously concluded that the EEA represented effectively a single market. This was attributed to the considerable trade flows

between EEA countries and the observation that several retailers source pet food on a European scale as well as brands being generally common throughout EEA countries. However, the Commission took a completely different view in its decision on *Nestlé/Ralston Purina*. It argued that pet food markets were at most national in nature, attributing this to the lack of cross-border trade and continuing price differences between member states. This view had profound consequences for the way in which the merger was treated. Rather than viewing the merger in its entirety for product classes across the whole of the EU, consideration was directed at the levels of competition in national markets. In this regard the Commission found that only three national markets – Spain, Italy and Greece – raised concerns about competition arising from the possibility of single-firm dominance. To allay these concerns Nestlé provided undertakings to offer exclusive licenses for certain brands (notably “Friskies” in Spain and “Chow” in Italy and Greece) and some plant capacity (in Spain). However, the decision to allow the merger to progress relatively unhindered indicates the EC’s belief that the merger broadly related to drawing on the strength of complementary positions in different product and national markets.

The recent Commission decisions on this sector point to a view of competition being relatively healthy. Critically, and perhaps relevant to the Mars/Royal Canin proposed merger, a number of features in the markets indicate that duopolistic dominance is not likely. First, the products are differentiated through branding, types of products, package sizes and categories. Second, the market has been dynamic, especially in regard to the faster growth in sales of dry pet foods compared to sales of wet pet foods. Third, the market has been characterised by a certain degree of innovation in product development and packaging. Fourth, own label, under powerful retailers’ guidance, will likely develop and put further downward pressure on prices. Furthermore, the

asymmetric positions of the two leading companies, in terms of Mars's strong position in wet foods and Nestlé being strong in dry foods, means that each of them has strong incentives to compete in the growing market. Finally, significant potential entrants can make inroads into this market as witnessed by recent new entry.

These elements, and particularly increasing retailer power, lend themselves to ensuring continued intense competition in this sector and the absence of any joint dominance concerns. The Commission's non-opposition to the Nestlé/Ralston Purina merger reflects this. However, it remains to be seen if a similar view is taken of the Mars/Royal Canin proposal. But there is sound economic logic behind this merger, notably the combining of complementary strengths, and strong reasons for believing that competition will continue to be intense post-merger. Problems associated with joint or single-firm dominance are unlikely to arise while the two leading players have such strong incentives to be combative and fight for market share and retailers can play them off against each other as well as using other suppliers.

## Conclusion

Over the last few years there has been an increasing tendency by competition authorities to take a tough stance against mergers in markets characterised by oligopolies, even where the market is clearly dynamic and a number of evenly sized competitors exist. In each case there may have been good, specific reasons for prohibiting the merger or enforcing

certain product/capacity divestments due to concerns about single-firm or joint dominance. However, unless competition analysis in such cases is sensibly applied and examines the exact competitive dynamics within the market, there is a very real prospect that pro-efficiency and pro-competitive mergers will be blocked or heavily restricted. This would send the wrong signal to business if it deterred parties from undertaking efficiency- and competition-enhancing mergers.

In the case of FMCG markets the key driver of mergers is to gain cost-efficiencies and enhance the competitive product offering. The intense competition which powerful retailers have placed the producers under not only drives this merger or restructuring requirement but also serves to ensure that subsequently producers cannot exploit their enhanced position. Moreover, retailers will continue to hold the whip hand because they ultimately have the greater flexibility in trading relationships (facing lower switching costs than producers) which they can be trusted to use to drive hard bargains and keep producers' prices down. In these particular circumstances, mergers amongst FMCG producers such as those presently occurring in the pet food market should generally be looked upon benignly and be seen as a necessary part of the overall competitive process.

<sup>1</sup> *Dalgety plc/Quaker Oats Company* (Case IV/M554 - 13/03/1995) and *Nestlé/Dalgety* (Case IV/M1127 - 02/04/1998).

<sup>2</sup> Case COMP/M2337 - 27/07/2001.

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